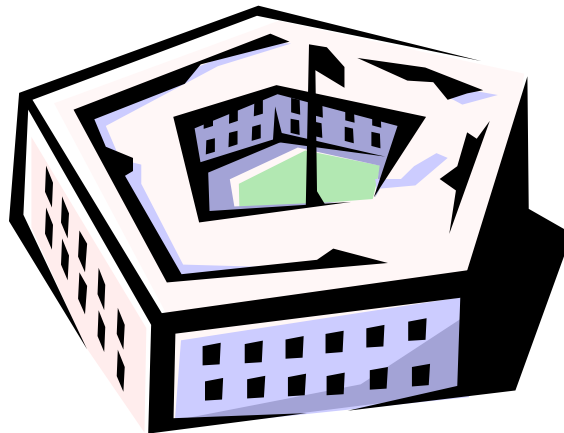




FY 2005 Defense-Wide Conference

Changes to the Office of Management and Budget (OMB) Circular A-123



*Peggy P. Johnson
Department of Defense
Management Control Program Coordinator,
Office of the Deputy Chief Financial Officer*



Sarbanes Oxley and What Some in Industry are Saying About Compliance

- Sarbanes Oxley Act requires:
 - Chief Executive Officers of publicly traded companies to certify the effectiveness of internal controls over financial reporting
 - &
 - The auditors who do business with the companies to provide an opinion on the effectiveness of internal controls over financial reporting



Sarbanes Oxley - Challenging Issues

Some Challenging Issues in Industry

Managing accountability - how to measure effectiveness of controls, identify deficiencies, and make people accountable.

How to push accountability to a broader group and not just finance.

The lack of mechanisms to monitor, enforce and improve controls.

How to distribute responsibility for monitoring controls to the appropriate managers.

How to establish a cost-effective strategy to sustain process implementation.

How to implement the process changes necessary.

How to setup a sustainable process to track deficiency resolution.

Many companies are relying too heavily on quick-fix software, that misses the mark for compliance.



Changes to OMB A-123

Impact & Implementation

| | CHANGES | IMPACT | IMPLEMENTATION |
|--------|---|--------------------------------|--|
| 1 | Changes the term management controls to internal controls. | None - But training important. | DoD policy May 2005. |
| 2 | Adds concept of reportable conditions. | None. | DoD policy May 2005. |
| 3 | Adds Appendix A: | | |
| 3 a | --- Requires separate statement of assurance (SOA) for financial reporting function as well as SOA for other functions. | All reporting entities. | DoD policy May 2005. |
| 3 b | --- Requires risk assessment and documentation of effectiveness | All reporting entities. | OMB to provide more guidance March 2005. |



Changes to OMB CIRCULAR A-123

Control Deficiency Defined -- Effective FY 2006

For both FMFIA overall and financial reporting:

- ❖ Control deficiency - exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis or could adversely affect the organization's ability to meet its internal control objectives.
 - ❖ Design deficiency - exists when a control necessary to meet the control objective is missing or an existing control is not properly designed, so that even if the control operates as designed the control objective is not always met.
 - ❖ Operation deficiency - exists when a properly designed control does not operate as designed or when the person performing the control is not qualified or properly skilled to perform the control effectively.



Control Deficiency Defined Example

Risk = Unauthorized access

Control = Electronic lock on the door

**Control Deficiency
(Unauthorized entry)**

Was entry due to a design or operation deficiency

**Design Deficiency
(Weak design of
lock)**

**Operation Deficiency
(Lock design good but
inoperable)**



Changes to OMB CIRCULAR A-123

Concept of Reportable Conditions -- Effective FY 2006

IMPORTANT: A-123 adds the concept of a reportable condition:

- FMFIA overall

- » **A control deficiency, or combination of control deficiencies, that in management's judgment because they represent significant weaknesses in the design or operation of internal control that could adversely affect the organization's ability to meet its internal control objectives.**
- » **Are not reported outside of the organization, but tracked for correction.**

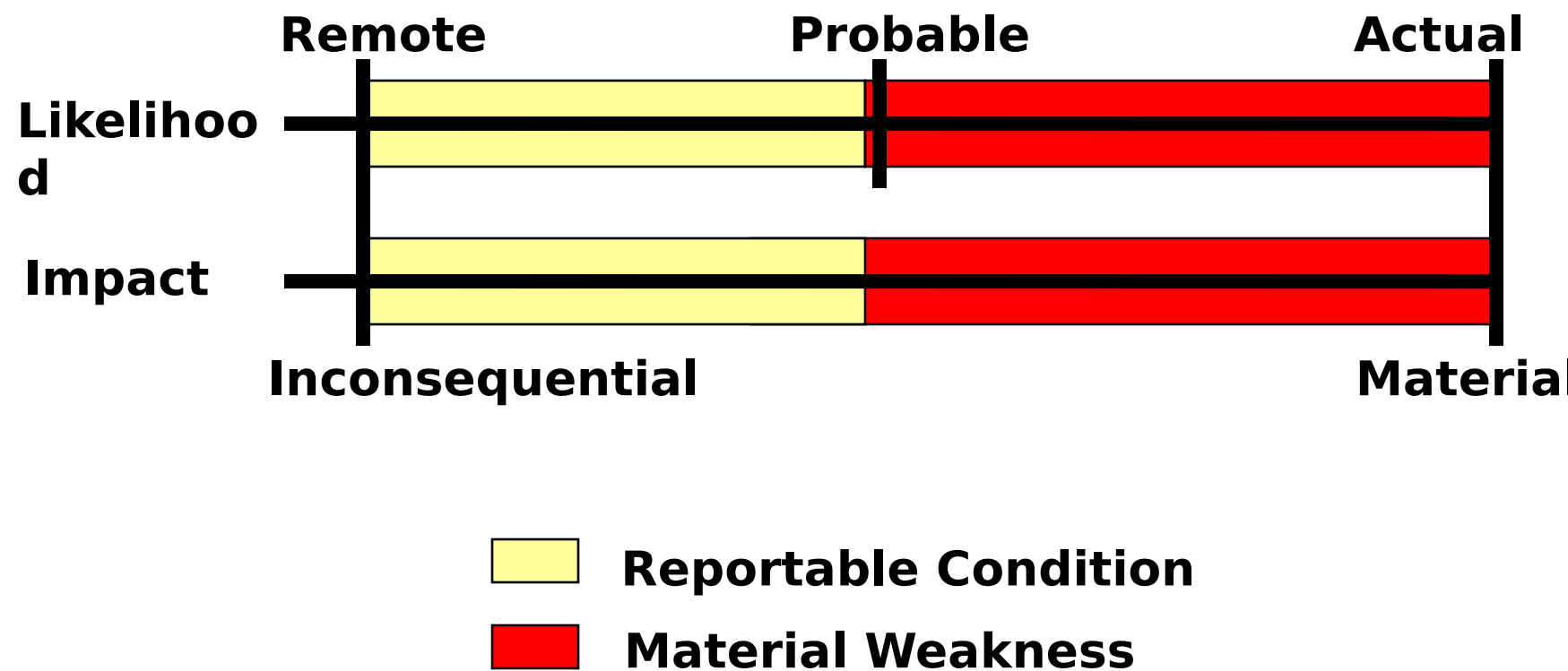
- Financial reporting

- » **A control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements, or other significant financial reports, that is more than inconsequential will not be prevented or detected.**
- » **Are not reported outside of the organization, but tracked for correction.**

- Remote means the chance of the future event, or events, occurring is slight.**



Reportable Condition or Material Weakness





Material Weakness Redefined

- FMFIA overall and financial reporting defined differently –
 - FMFIA overall material weaknesses = Reportable conditions in which the agency head determines to be significant enough to report outside of the agency (organization).
 - Financial reporting material weaknesses = Reportable condition, or combination of reportable conditions, that results in more than a remote likelihood that a material misstatement of the financial statements, or other significant financial reports, will not be prevented or detected.
 - Material weaknesses and a summary of corrective actions shall be reported to OMB and Congress through the PAR.
 - Progress against corrective action plans should be periodically assessed and reported to agency management.
- Separate Statements of Assurance will be required for FMFIA overall and financial reporting.